***United States Court of Appeals***

***for the Second Circuit***

# PETITION FOR REHEARING

ORIGINAL

# 75-7503

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P/S

## United States Court of Appeals
FOR THE SECOND CIRCUIT

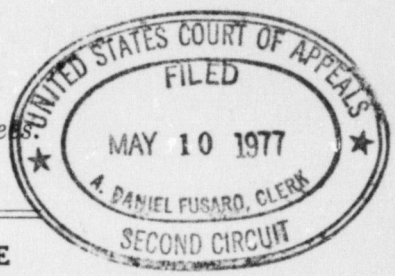
SUSAN TANNENBAUM,

*Plaintiff-Appellant,*

*against*

ROBERT G. ZELLER, *et al.*,

*Defendants-Appellees.*




**BRIEF OF PLAINTIFF-APPELLANT IN RESPONSE TO PETITION FOR REHEARING**

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UNITED STATES COURT OF APPEALS
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Docket No. 75-7503

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SUSAN TANNENBAUM,

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BRIEF OF PLAINTIFF-APPELLANT IN
RESPONSE TO PETITION FOR REHEARING

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Plaintiff-Appellant submits this brief in response to (a) the petition of Defendants-Appellees F. Eberstadt & Co., Inc., F. Eberstadt & Co., Managers and Distributors, Inc., and Robert G. Zeller for rehearing of the decision of a panel of this Court rendered March 4, 1977, or, alternatively, for rehearing in banc and (b) the brief of the Investment Company Institute, amicus curiae in support of rehearing. The time of Plaintiff-Appellant to file her responsive brief was extended by the Court to May 11, 1977.

## Preliminary Statement

As stated at the outset of this Court's decision of March 4, 1977, this action was commenced as a stockholder's derivative action on behalf of Chemical Fund, Inc. ("Fund"), and sought damages arising from:

> (1) "...alleged unlawful failure to recapture portfolio brokerage commissions for the benefit of the Fund"; and
>
> (2) "...alleged inadequate disclosure of the Fund's brokerage practices to Fund shareholders". Slip op. 6265.

Each of those issues was briefed and argued on appeal. In its March 4 decision the Court rejected the contentions of Plaintiff-Appellant (a) that the Fund's manager and interested directors had a duty to recapture excess commissions for the Fund's benefit under the Fund's charter and its management and distribution agreements and (b) that the failure to recapture violated Section 36 of the Investment Company Act of 1940. The Court also rejected the contention (c) that the manager and interested directors had violated their duty of disclosure to the independent directors under Moses and Fogel.

The Court concluded, however, that the proxy statements distributed to the Fund's shareholders for the years 1967-1971 violated the disclosure provisions of the federal

securities laws, because they failed, among other things, to advise the shareholders, who had an express statutory right to approve, terminate or renegotiate the Fund's management contract: (a) that substantial portions of the Fund's brokerage commissions were recapturable for the Fund's benefit and (b) that the Fund's board -- for reasons never disclosed -- had decided not to recapture (slip. 6328-29). Defendants-Appellees seek rehearing of that issue.

It is not suggested by Defendants-Appellees that the issue for which they seek rehearing was not thoroughly briefed and argued on appeal, nor is it urged that the Court overlooked or misapprehended any controlling point of law or issue of fact. Indeed, the focus of the petition is decidedly away from the merits of the issue on which Plaintiff-Appellant prevailed -- namely, the adequacy of the disclosure in the Fund's proxy statements. In seeking rehearing, Defendants-Appellees rely primarily on a presumed "disaster for the mutual fund industry" which it is claimed will result from the Court's decision and on alleged procedural infirmities in the District Court.

For the reasons hereinafter stated, we respectfully submit that Defendants-Appellees have not demonstrated any proper basis for rehearing, and their petition should be denied.

## Argument

The contentions urged by Defendants-Appellees in support of rehearing are, we submit, misleading and incomplete. Neither the petition nor the amicus brief directly addresses itself to the cogent analysis found at pages 6319-32 of the panel's decision regarding the adequacy of disclosure in the Fund's proxy statements. They do not attack the consistency or logic of the panel's reasoning nor do they point to any overlooked or misapprehended precedent. The thrust of their argument is that the panel should have been more alert to the "policy implications" of its decision (petition, p. 6) -- considerations which, in our view, should more properly be raised in a legislative forum. We nonetheless respond briefly to the points raised.

A. The contention that the Court's decision "spells disaster for the mutual fund industry".

Defendants-Appellees urge at page 4 of the petition that, if the panel's decision stands, "most mutual fund proxy statements will be deemed false and misleading, most mutual fund management contracts are in limbo and mutual fund managers and directors stand exposed to huge judgments...." We find it difficult to respond to these contentions, because they are

addressed to matters wholly outside the record in this case, are supported by factual assertions that seem to be dubious at best and, in any event, are irrelevant.

First, as suggested at pages 2 and 9 of the amicus brief, because of the advent of negotiated brokerage rates, recapture no longer has the significance for mutual funds that it once had. Through competition and negotiation "excess" commission dollars have been eliminated, and commission charges have been driven down to the point that recapture is not practicable. Furthermore, most avenues of recapture have been closed off in recent years, first through administrative action and later by legislation. In February 1972 the SEC issued its Policy Statement on the Future Structure of the Securities Markets. The SEC, having forced the abolition of give-ups in December 1968, stated in its report that reciprocal practices must also be terminated. In response, the NASD proposed in 1972 a rule to abolish reciprocals, which became effective in July 1973. In 1973, the SEC promulgated Rule 19b-2, which greatly circumscribed the ability of mutual funds to obtain reductions of commissions through institutional membership on the exchanges. These developments were capped by the adoption

of the Securities Acts Amendments of 1975, which eliminated transactions for one's own account or that of an associate. See Fogel v. Chestnutt, 533 F.2d 731, 740-74 (2d Cir. 1975), cert. denied, 45 U.S.L.W. 3250 (U.S. Oct. 4, 1976).

The virtual elimination of recapture over the last several years makes somewhat puzzling the notion that the panel's decision, if permitted to stand, "spells disaster for t[illegible]ual fund industry" (petition, p. 3) or will trigger a "...whole new round of litigation" (amicus brief, p. 10). If, as the amicus asserts in its brief (pp. 9-10), recapture is no longer a viable technique (in stark contrast to the situation that prevailed in the industry prior to 1972), there could hardly have been a disclosure issue in the last several years so far as a fund's proxy statements were concerned, and the alleged impact of the panel's decision on fund management contracts is, we submit, chimerical.

The assertion that the panel's decision will subject members of the industry to horrendous damage claims is equally unsound. Commencing with the Moses decision in June 1971, mutual funds did begin to disclose in their proxy statements

(a) the possibility of recapture and (b) the determination of the fund's board with respect to recapture. (Indeed, as explained at length in the panel's decision (slip op. 6322-24), that is precisely what occurred in the case of Chemical Fund, starting with its 1972 proxy statement.) Although the amicus intimates that fund proxy statements generally do not contain these disclosures, its brief is significantly vague as to date. The absence of such disclosures in current proxy statements undoubtedly reflects the fact that recapture is no longer a viable alternative. The absence of such disclosures in proxy statements issued prior to the Moses decision is also not surprising, since it was evidently not the practice (as shown by Moses, Fogel and settlements achieved in a substantial number of similar lawsuits) for fund managers to bring to the attention of the independent directors the fact that recapture of commissions for the fund's benefit was a distinct possibility. We think it extremely unlikely, however, that sophisticiated fund managers, confronted with the clear threat of litigation following the Moses decision, did not fully disclose in proxy statements the policy of the fund with respect to recapture so long as that technique remained viable. In short, the

potential for new litigation arising from the panel's decision (if it exists at all) is in all probability limited to proxy statements issued in 1971 and prior years and circumscribed by applicable statutes of limitations.

Some comment also seems appropriate on the applicable measure of damages in cases where, as here, fund proxy statements are found not to have made proper disclosures regarding the possibility of recapture. Defendants-Appellees suggest that, because the Fund's management contract for the years 1967-1971 may be deemed "void" by reason of Section 47(b) of the Investment Company Act, they may be required to pay the Fund damages in an amount equal to the entire management fee for each year. While we take no position at this time regarding the appropriate measure of damages,* we think our adversaries' view somewhat fanciful. In Lutz v. Boas, 171 A.2d 381 (Del. Ch. 1961), Chancellor Seitz, confronted with the same issue, rejected the argument that the defendants

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*As the panel noted in its March 4 decision (slip op. 6265), the action was tried in the District Court on the issue of liability only. In remanding to the District Court, the panel expressly left open the issue of damages (slip op. 6332).

should be compelled to repay the entire management fee and adopted a measure of recovery based on equitable principles. That approach seems unlikely to lead to the "huge liabilities" perceived by our adversaries.

B. The contention that the SEC "rejected" in 1972 any requirement that the possibility of recapture be disclosed.

Both the petition and the amicus brief place heavy emphasis on the notion that the SEC "rejected" any requirement that fund proxy statements disclose the possibility of recapture for the benefit of the fund when it adopted new guidelines for the preparation of fund prospectuses in 1972. In doing so, they:

(a) ignore the fact that both the 1969 guidelines (Release No. 5634) and the 1972 guidelines (Release No. 7220) are directed only to prospectuses, not proxy statements;

(b) ignore the fact that prospective purchasers of fund shares (as opposed to existing shareholders) are not authorized, or asked, to approve or reject the fund's management contract and by implication the fund's policy toward recapture (the only issue of concern to a prospective purchaser is whether the fund

does, or does not, have a policy to effect recapture);

(c) ignore the fact that the 1969 guidelines were prepared in light of portfolio practices that were tolerated at the time but, as a result of the Moses decision and the changing attitude of the SEC, had largely been proscribed by the time the 1972 guidelines were issued;

(d) ignore the following statement in the 1972 guidlines (p. 2):

> "...the public is cautioned that the opinions expressed in this release are not, and do not purport to be, an official expression of the Commission's views."

In short, the change in the guidelines for fund prospectuses from 1969 to 1972 hardly constitutes an authoritative declaration by the Commission that a fund need not disclose in its proxy statement, when asking shareholders to consider and vote on the management contract, the fact that management has considered and rejected recapture.

Similarly, we think that the petition and amicus brief vastly overstate the significance of the fact that the Fund's proxy statements, like those of all other mutual funds,

were routinely filed with the SEC. As noted in the panel's opinion at pages 6276-77, the SEC was admittedly less than consistent in its approach to recapture and the overriding problem of excess commissions. In light of the SEC's own uncertainty it is not surprising that it did not promulgate rules or policies setting forth the precise kinds of disclosures required in fund proxy statements in all circumstances. In any event, under Section 15(a) of the Investment Company Act the shareholders of a fund have been given significant voting powers with respect to the approval or rejection of the fund's management contract. That being so, the conclusion is inescapable that the shareholders are entitled to full disclosure of every material fact bearing on the matter under consideration, irrespective of the directors' views regarding the merits of the proposal.

C. The contention that the disclosure issue was not raised in the District Court.

Defendants-Appellees urge in their petition, as they earlier urged in their brief on appeal, that the question of the adequacy of disclosure in the Fund's proxy statements,

annual and quarterly reports and prospectuses was not properly raised in the District Court. The panel acknowledged that such an argument had been made but rejected it (slip op. 6326, fn.34)*

Defendants-Appellees again make the same argument. We repeat our earlier rejoinder (Reply Brief, p. 29)

> "...Defendants assert that these claims are 'mere after-thoughts' (p. 48). Although neither the complaint nor the pre-trial order specifically spells out plaintiff's non-disclosure claims, they are integrally related to plaintiff's other claims; the documents relied on were introduced in evidence at the trial without any objection by defendants' counsel (Tr. 10-11); defense witnesses were questioned about the disclosures in those documents (Tr. 135-138, 196-199); the issues were briefed before the District Court; and the District Court specifically dealt with those issues in its opinion. (A-72 ff.)...."

Additional argument is made for rehearing on the ground that plaintiff's counsel (a) did not focus the trial court's attention on the disclosure issue in his opening

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*Under Rule 15(b) F.R.C.P. the District Court is authorized to conform the pleadings to the issues raised and evidence presented at the trial, even after judgment. In view of this Court's March 4 decision, a motion pursuant to that Rule would seem appropriate.

statement and (b) asked only one question of defendants' witnesses regarding the disclosures.

It is respectfully submitted that all of the Fund documents in question, namely, the proxy statements, annual and quarterly reports and prospectuses, speak eloquently for themselves. All of these documents -- prior to 1972* -- are silent on the availability of recapture for the Fund's benefit. From plaintiff's perspective little purpose would have been served in asking defendants' witnesses for elaboration. More significantly, however, Defendants-Appellees fail to suggest in their petition how the patent deficiencies of those documents could be remedied by rehearing or a new trial.

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*This action was commenced on May 11, 1971. The Moses opinion was handed down on June 23, 1971. The Fund's 1971 proxy statement is dated March 31, 1971.

## Conclusion

For the reasons stated, the petition for rehearing should be denied.

Dated: New York , New York
May 11, 1977

Respectfully submitted,

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375—Affidavit of Service The Reporter Co., Inc., 11 Park Place, New York, N. Y. 10007

UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

SUSAN TANNENBAUM,
Plaintiff-Appellant,

against

ROBERT G. ZELLER, et al.,
Defendants-Appellees.

**AFFIDAVIT OF SERVICE**

STATE OF NEW YORK,
COUNTY OF , ss:

Bernard S. Greenberg being duly sworn,

deposes and says that he is over the age of 21 years and resides at 162 E 7th St NY, NY

That on the 10th day of May 19 77 at 250 Park Ave N.Y. N.Y.

he served the annexed BRIEF OF PLAINTIFF-APPELLANT IN RESPONSE TO PETITION FOR REHEARING ON WALSH & FRISCH, ESQS. upon

in this action, by delivering to and leaving with said Two 2 true copies thereof.

DEPONENT FURTHER SAYS, that he knew the person so served as aforesaid to be the person mentioned and described in the said

Deponent is not a party to the action.

Sworn to before me, this 10th day of May 19 77

Bernard S Greenberg

Roland W. Johnson

ROLAND W. JOHNSON
Notary Public, State of New York
No. 4509705
Qualified in Delaware County
Commission Expires March 30, 19 79